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FCC MAIL ROOM

Mr. William S. Catton
Acting Secretary
Federal Communications Commission
1919 M Street, Room 222
Washington, D.C. 20554

Re: MM DOCKET NO. 93-215

Dear Mr. Catton:

Enclosed are an original and fifteen copies of the Comments of the California Cable Television Association in the above referenced proceeding.

Please return a date-stamped copy to us in the envelope provided.

Yours truly,

John E. Puhalla

John E. Puhalla

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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992	)	MM Docket No. 93-215
	)	
Rate Regulation	)	

COMMENTS OF THE CALIFORNIA CABLE TELEVISION ASSOCIATION

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August 24, 1993

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SUMMARY

The cost-of-service (COS) rules governing the rates that cable television operators can charge for the provision of cable television on the basic service and the cable programming tiers must be consistent with the Fifth and the Fourteenth Amendments to the Constitution (particularly their requirement of due process under the law and their prohibition against unconstitutional confiscation of property), the Administrative Procedure Act's prohibition against arbitrary and capricious agency action, and the legislative intent of the Cable Television Consumer Protection and Competition Act of 1992.

Congress has given the Federal Communications Commission (FCC) a broad mandate to create rules with respect to rate regulation. However, given the precedents in this area, these rules must have the effect of leading to just and reasonable rates. The courts require the FCC to balance the interests of consumers and investors. Cable television operators are entitled to enough revenue to cover not only their operating expenses but also their capital cost of business. They are entitled to service their debt and to issue dividends on their stock. They are entitled to a rate of return on equity commensurate with the returns on investments of other enterprises having a corresponding degree of risk. The return on equity must be sufficient to maintain confidence in the financial integrity of cable television systems so that they can maintain their credit and attract capital. It is essential that the FCC also take into

account the interest of consumers the public policy that rate regulation rules not deter cable television operators from expanding their plant.

The FCC's decision must not be arbitrary and capricious; it must rest on an evidentiary record. In this proceeding, the FCC is under an obligation to examine the relevant data concerning the economics of the cable television industry and make a rational connection between the issues raised and the evidence presented in this docket and the COS rules propounded.

The Commission must examine the economic impact of COS rules on the industry before propounding such rules in order to have a reasonable basis to draw conclusions about issues such as original cost, acquisition premiums, and rate of return.

The FCC has proposed to regulate the cable television industry using traditional COS regulation as a "backstop" to its benchmark regulatory method. But such traditional COS regulation is based on traditional utility economics, which the Supreme Court characterized, in Duquesne, as: "the risks a utility faces are in large part defined by the rate methodology because utilities are virtually always public monopolies dealing with an essential service, and so relatively immune to the usual market risks."

Cable television is an industry with neither a monopoly on its product, television service, nor does it have, in television entertainment, an essential service.

CCTA has concluded that the FCC's proposed COS system, based on a traditional utility model, unless modified, will likely result in confiscatory rates for many systems and have negative impacts on both the industry and long-term subscriber interests. CCTA believes that the FCC must take the following items into account:

1. Cable service is not essential service, and cable subscribers levels are more price-sensitive than utility services.
2. Cable rates for many systems are below those which would be allowed under traditional cost-of-service regulation.
3. Cable operators have a different time pattern of cost recovery than traditional utilities.
4. Cable operators have developed significant intangible assets, which benefit consumers, that they should be permitted to recover.
5. The cable industry represents a higher level of risk than utilities.

The FCC must take these unique characteristics of the cable television industry into account and frame rules that are appropriate for the cable television industry. To this end, the Commission's rules must provide an opportunity for systems that are not able to charge COS rates because of market constraints to earn a return by providing them with methods to reduce the front-end loading problem, must permit cable companies to recoup their acquisition premiums, and must permit cable television operators to have an opportunity to earn a rate of return commensurate with the higher risks assumed in their investments.

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992 Rate Regulation	)	MM Docket No. 93-215

COMMENTS OF THE CALIFORNIA CABLE TELEVISION ASSOCIATION

The California Cable Television Association[1], which represents cable operators that serve over six million California residents, submits these comments in response to the Federal Communications Commission's[2] Notice of Proposed Rulemaking in this docket.[3]

INTRODUCTION

The cost-of-service[4] rules proposed in the NPRM are consistent with rate regulation of traditional utilities. These rules govern the setting of rates for cable television by

[1] Referred to as "CCTA".

[2] Referred to as "Commission" or "FCC".

[3] In the Matter of Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992. Notice of Proposed Rulemaking (NPRM). MM Docket No. 93-215. FCC 93-353. (rel. July 16, 1993).

[4] Referred to as "COS".

franchise authorities on the basic service tier and by the Commission on the cable programming tier.[5] COS rates must be consistent with the Fifth and the Fourteenth Amendments to the Constitution (particularly their requirement of due process under the law and their prohibition against unconstitutional confiscation of property), the Administrative Procedure Act's prohibition against arbitrary and capricious agency action,[6] and the legislative intent of the Cable Television Consumer Protection and Competition Act of 1992.[7]

Unlike most regulated utility services, cable television service is not an essential service. In fact, in many markets cable penetration rates are only in the 30% to 50% range. Cable television services provide subscribers with entertainment, information, and other video programming services. However, subscribers have numerous alternative sources for the end products provided by cable. Therefore, cable customers are not "captive" in the same sense that most customers of traditional utilities are. The fact that cable service is not universally taken demonstrates that it is not an essential service. Also, the number of subscribers to cable television service is price-sensitive, whereas the number of utility customers is largely insensitive to price. Thus, in spite of large increases in

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[5] 47 U.S.C. 543.

[6] See 5 U.S.C. 706(2)(A).

[7] Pub. L. No. 102-385, 106 Stat. 1460 (1992) (Referred to as the "1992 Cable Act" or "1992 Act" or "Act.")

electric rates over the last ten to twenty years, electric service is still almost universal. This fact demonstrates that cable subscription rates are more influenced by price.

It is often said that COS regulation substitutes for the market. Regulated monopoly utilities are allowed rates based on COS in lieu of market prices. Thus, in one sense, the COS rates are the "market" price for a regulated utility.

Prior to the rate reregulation of cable, the prices that almost all cable companies charged were unregulated from 1986. However, the unregulated market prices were <u>not</u> in general equal to the COS prices. The industry was pricing its services based on a large number of factors. Economic theory states that a firm prices its services to maximize its long-term profit. Also, this pricing is driven by economic considerations, not by accounting-based COS considerations. Therefore, prices are a function of the firm's economic cost structure, and prices reflect the marginal costs associated with serving customers and the customers' price elasticity. In addition, for a subscription business such as cable television, as the subscriber will provide a stream of revenues in the future, it is economically rational for a cable company to price its services to attract subscribers who will provide a long-term revenue stream. Thus, the relationship between market prices (or benchmark prices based on market prices) is an empirical question.

Empirical evidence suggests that cable system economics, coupled with the discretionary nature of cable service, may not permit systems to follow a COS price path. Using system financial and operating data provided by California cable companies, CCTA's consulting economists, Barakat & Chamberlin, developed preliminary pro forma COS rates based on the Commission's proposed COS standards, excluding acquisition intangibles. In seven of ten systems, COS rates were higher (up to 200% to 340% higher) than existing rates. Likewise, COS rates were as much as 200% higher than benchmark rates in six systems.

This analysis demonstrates that there is no simple relationship between prices and COS rates. In many cases, COS rates can be expected to exceed benchmark rates.

Although cable is not an essential service, most cable companies have increased their number of subscribers and their rates over time. Yet, with respect to costs, the primary cost associated with establishing a cable system is the initial system investment. That investment is depreciated over time. Therefore, COS declines over time, but revenues typically increase. The exact relationship between the price and the COS curves is a function of the cost, the number of subscribers, and the prices charged. However, the basic pattern of cost recovery for cable television systems is significantly different from that of other utilities. Numerous studies of cable investments and acquisitions have confirmed this pattern. It is the pattern seen in many subscriber-type businesses.

Under the 1992 Act's regulatory framework, rates for basic service are set at the franchise level. COS rates vary across franchises as a function of investment and subscriber levels in each franchise. For cable companies, the market for each system will present unique questions. This regulation places additional complications in developing a uniform and consistent COS regulatory approach.

Unlike utilities that have been regulated for a large number of years, over the past ten years the cable television industry has undergone a period of consolidation through acquisitions. The acquiring companies have generally paid a premium over the value of the cable plant for the companies they acquired. The balance sheets of the acquiring companies contain significant values associated with the intangible assets of these companies (referred to as acquisition premiums) that may not be included in the rate bases under traditional COS regulation.

For cable companies these acquisition premiums are significant. During the ten years ending December 31, 1992, over 3,300 acquisitions of cable systems occurred representing total sales of over 47.4 million subscribers. The unamortized acquisition premium as of the end of 1992 for 22 large publicly held cable companies is estimated to total $11 billion. This amount equals approximately 60% of these companies' capital. The total industry acquisition premiums of cable companies are estimated to be $17 billion to $20 billion.

Cable television systems employ a myriad of intangible assets, some of which are a prerequisite to providing cable television service. Other intangible assets, while not a prerequisite for service, have significant impact on the provision of service. Unlike the public utility industry, the cable television industry operates in a discretionary market, in which the resources it employs in developing these intangibles could be expected to pay dividends in the form of higher earnings and higher returns than would be expected from the use of the tangible assets alone.

The intangible assets available to cable operators include franchise operating rights, programming contracts, licenses, access agreements, management and operating systems, software, service marks, assembled work force, and subscriber lists. A return should be allowed on the value of these intangibles.

Finally, the cable television industry faces a higher level of investment risk than most regulated utilities. Traditional regulated utilities have exclusive franchises, face limited competition for their primary service, and provide a service that is usually a public necessity. Cable television systems, however, have nonexclusive franchises, face broad competition from the providers of all other entertainment and video programming services, and provide an optional service to which nearly 40% of American households choose not to subscribe. Traditional utilities generally employ mature technologies, whereas cable television systems are forced to deploy new technologies constantly to be able to compete. In the area of financial risk, traditional utilities have conservative capital structures and predictable dividend growth, whereas the cable television industry is highly leveraged. In the area of risk-taking, traditional utilities usually do not assume risk without first receiving approval from regulatory agencies, whereas cable television systems must be willing to take risks as a function of the economic necessity to stay ahead of their competition. Given this higher level of investment risk, the Constitution supports CCTA's conclusion that cable companies are entitled to a higher rate of return than traditional utilities.

I. THE CONSTITUTIONAL STANDARD FOR COS REGULATION RULEMAKING REQUIRES THAT THE COMMISSION MAKE RULES THAT ARE REASONED IN LIGHT OF THE RECORD AND THAT LEAD TO RATES WITHIN THE ZONE OF REASONABLENESS.

When the courts ultimately review this rate regulation rulemaking or rates set under the FCC's standards, their analysis will involve a two-prong test: 1) Is the decision making reasoned in light of the record? and 2) Is a change in regulatory policy consistent with the congressional mandate from which the agency derived its authority?

A. The FCC's Decision Must Consider All Factors that Congress Intended It to Consider, Be Consistent with the Record before the Commission, and Examine Credible Alternatives before the Commission or the Decision Will be Arbitrary and Capricious.

For an agency's decision to be "reasoned in light of the record," the Supreme Court has explained:

> Normally, an agency rule would be arbitrary and capricious if the agency has relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem,

> offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise.[8]

The second question of whether or not regulatory policies are consistent with congressional mandate was examined in Farmers Union Central Exchange v. FERC.[9] In that case, the United States Court of Appeals for the District of Columbia found that an order of the Federal Energy Regulatory Commission[10] contravened its statutory responsibility to ensure that oil pipeline rates were "just and reasonable" and remanded the case for further proceedings to FERC.[11] In that case, the Circuit Court of Appeals stated that it had to look at agency decision-making under the "arbitrary and capricious" standard.[12] Finally, the

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[8] Motor Vehicle Manufacturers Association v. State Farm Mutual Auto Insurance Company, 463 U.S. 29, 43 (1983)

[9] Farmers Union Central Exchange v. FERC, 734 F.2d 1486 (D.C. Cir. 1984) (hereafter referred to as "Farmers Union").

[10] Hereafter referred to as "FERC".

[11] Id.

[12] Under the "arbitrary and capricious" standard, a reviewing court must conduct a "searching and careful" inquiry into the record in order to assure itself that the agency has examined the relevant data and articulated a reasoned explanation for its action including a "rational connection between the facts found and the choice made." Normally, an agency rule would be arbitrary and capricious if the agency has relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise. Most fundamentally, our task is to ensure that the [agency] engaged in reasoned decision making. Id., at 1499-1500.

law requires that the FCC consider credible alternatives presented to it and pass judgment on those alternatives:

> It is well established that an agency has a duty to consider responsible alternatives to its chosen policy and to give a reasoned explanation for its rejection of such alternatives.[13]

B. The Commission's Rules Must Permit Cable Companies to Maintain Their Credit, Attract Capital and Earn a Rate of Return Commensurate with Returns in Other Enterprises Having Corresponding Risks.

In FPC v. Hope,[14] the United States Supreme Court reversed almost fifty years of practice in this area as established in Smyth v. Ames.[15] Hope holds that the focus of the courts in evaluating whether or not a ratemaking was confiscatory should be

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[13] Id., at 1511 citing Motor Vehicle Manufacturers Association, 103 S. CT. at 2869-71. The Court went on to explain the requirement to consider responsible alternatives within the arbitrary and capricious standard: "The 'arbitrary and capricious' standard does not 'broadly require an agency to consider all policy alternatives in reaching decision.' Agency action 'cannot be found wanting simply because the agency failed to include every alternative device and thought conceivable by the mind of man ... regardless of how uncommon or unknown that alternative may have been.' The alternatives to the ICC rate base formula discussed herein, however, are significant and viable, and were fully discussed during the Williams proceeding." Id. citing Motor Vehicle Mfrs. Assn, 103 S. Ct. at 2871; Vermont Yankee Nuclear Power Corp. v. NRDC, Inc., 435 U.S. 519, 551, 55 L. Ed. 2d 460, 98 S. Ct. 1197 (1978).

[14] 320 U.S. 591 (1944) (Per Douglas).

[15] 169 U.S. 466 (1898).

on the result reached by the administrative body, not the method employed by the administrative body.[16]

The Court went on to state that the regulatory body was required to look at the congressional intent and to balance the interests of the investors and consumers.[17]

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[16] "It is not theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the Act is at an end. The fact that the method employed to reach that result may contain infirmities is not then important. Moreover, the Commission's order does not become suspect by reason of the fact that it is challenged. It is the product of expert judgment which carries a presumption of validity. And he who would upset the rate order under the Act carries the heavy burden of making a convincing showing that it is invalid because it is unjust and unreasonable in its consequences." FPC v. Hope, 320 U.S. at 602.

[17] "The rate-making process under the Act, i.e., the fixing of 'just and reasonable' rates, involves a balancing of the investor and the consumer interests. Thus we stated in the Natural Gas Pipeline Co. case that 'regulation does not insure that the business shall produce net revenues.' But such considerations aside, the investor interest has a legitimate concern with the financial integrity of the company whose rates are being regulated. From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. By that standard the return to the equity owner should be commensurate with returns on investments in other enterprise having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital. The conditions under which more or less might be allowed are not important here. Nor is it important to this case to determine the various permissible ways in which any rate base on which the return is computed might be arrived at. For we are of the view that the end result in this case cannot be condemned under the Act as unjust and unreasonable from the investor or company viewpoint." Id. at 603 citing 315 U.S. p.590; Cf. Chicago & Grand Trunk Ry. Co. v. Wellman, 143 U.S. 339, 345-346; Missouri ex rel. Southwestern Bell tel. Co. v. Public Service Commission, 262 U.S. 276, 291 (Mr. Justice Brandeis concurring).

This standard has governed the analysis of claims of confiscation in utility ratemaking for almost fifty years. Three recent decisions of the District of Columbia Circuit Court of Appeals illustrate how the courts will evaluate the balance to be achieved by agency decision making.

1. Farmers Union v. FERC

The Farmers Union opinion refers to the "zone of reasonableness" test established by the courts for review of agency determinations of rates:

> We begin from this basic principle, well established by decades of judicial review of agency determinations of "just and reasonable" rates: an agency may issue, and courts are without authority to invalidate, rate orders that fall within a "zone of reasonableness," where rates are neither "less than compensatory" nor "excessive." When the inquiry is on whether the rate is reasonable to a producer, the underlying focus of concern is on the question of whether it is high enough to both maintain the producer's credit and attract capital. To do this, it must, inter alia, yield to equity owners a return "commensurate with returns on investments in other enterprises having corresponding risks," as well as cover the cost of debt and other expenses.... When the inquiry is whether a given rate is just and reasonable to the consumer, the underlying concern is whether it is low enough so that exploitation by the [regulated business] is prevented. The "zone of reasonableness" is delineated by striking a fair balance between the financial interests of the regulated company and "the relevant public interests, both existing and foreseeable."[18]

The court then went on to talk about the complex inquiry that an agency should pursue to delineate whether or not a rate was within the zone of reasonableness:

[18] Farmers Union, 734 F.2d at 1502.

> The delineation of the "zone of reasonableness" in a particular case may, of course, involve a complex inquiry into a myriad of factors. Because the relevant costs, including the cost of capital, often offer the principal points of reference for whether the resulting rate is "less than compensatory" or "excessive," the most useful and reliable starting point for rate regulation is an inquiry into costs. At the same time, non-cost factors may legitimate a departure from a rigid cost-based approach. The mere invocation of a non-cost factor, however, does not alleviate a reviewing court of its duty to assure itself that the Commission has given reasoned consideration to each of the pertinent factors. On the contrary, "each deviation from cost-based pricing [must be] found not to be unreasonable and to be consistent with the Commission's [statutory] responsibility." Thus, when FERC chooses to refer to non-costs factors in ratesetting, it must specify the nature of the relevant non-cost factor and offer a reasoned explanation of how the factor justifies the resulting rates.[19]

2. Jersey Central Power & Light v. FERC

In Jersey Central Power & Light v. FERC[20] the United States Court of Appeals for the District of Columbia Circuit[21] held that FERC had not ensured that resulting rates would be just and reasonable when it did not consider facts necessary to determine whether a rate order met the requirements of Hope.

The majority opinion states that "in the face of a serious Hope challenge" an agency is required to make findings, perform a balancing of the investor and consumer interests, offer a reasoned consideration of the regulated company's allegations and

[19] Id. at 1502-1503.

[20] 1810 F.2d 1168 (D.C. Cir. 1986) (hereafter referred to as "Jersey Central").

[21] En banc (per Bork joined by Bader-Ginzberg, among others.)

proffered testimony, and apply the record to the law so that rates within the zone of reasonableness can result.[22] The court goes to great lengths to give a detailed and lengthy account of Hope and its progeny.[23] The decision concludes:

> The teaching of these cases is straightforward. In reviewing a rate order courts must determine whether or not the end result of that order constitutes a reasonable balancing, based on factual findings, of the investor interest in maintaining financial integrity and access to capital markets and the consumer interest in being charged non-exploitative rates. Moreover an order cannot be justified simply by a showing that each of choices underlying it was reasonable; those choices must still add up to a reasonable result.[24]

In explaining its reasoning, the Court quotes liberally from Justice Harlan's decision in the Permian Basin Area Rate Cases that a court must assure itself that "each of the order's essential elements is supported by substantial evidence" and that "the order may reasonably be expected to maintain financial integrity, attract necessary capital, and fully compensate investors for the risks they have assumed, and yet provide appropriate protection to the relevant public interest, both existing and foreseeable."[25]

The Court in Jersey Central stresses that it is the agency's responsibility to protect the investors' interests in strong companies:

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[22] Id. 1810 F.2d at 1178.

[23] Id. at 1175-1178.

[24] Id. at 1177-78.

[25] Id. at 1177 citing Permian Basin Area Rate Cases, 390 U.S. 747, 792 (1968).

> Hope Natural Gas talks not of an interest in avoiding bankruptcy, but an interest in maintaining access to capital markets, the ability to pay dividends, and general financial integrity. While companies about to go bankrupt would certainly see such interest threatened, companies less imminently imperiled will sometimes be able to make that claim as well.[26]

3. AT&T v. FCC

Finally, the U.S. Court of Appeal for the District of Columbia Circuit held that an FCC rule requiring interexchange telephone carriers to refund the earnings that they had received in excess of expected rate of return on capital by having them factored into their rates was arbitrary and capricious.[27]

The court described how the FCC was required to balance the investor and consumer interests in creating a zone of reasonableness for such rates:

> Since the determination of a carrier's allowed rate of return requires a balance of investor and consumer interests, the rate of return, as a balance point, represents "at the same time a minimum and a maximum" allowable return. If the rate were higher, the balance would tip in favor of the investor; if lower, it would tip in favor of the consumer. According to the Commission, therefore, its selected rate of return is the proper balance between these interests and hence the minimum return the carrier requires.[28]

The AT&T decision notes that a rate order must be consistent with the constitutional doctrine that

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[26] Id. at 1180.

[27] AT&T v. FCC, 836 F.2d 1386 (D.C. Cir. 1988) (hereafter referred to as "AT&T").

[28] Id. at 1390.

> [A]n agency rate order "viewed in its entirety" must produce a just and reasonable "total effect" on the regulated business. Investors in a carrier, after all, must invest in the carrier as a whole, and not just in one or another business segments.[29]

Finally, the court expressed confidence that the FCC could create other ratemaking rules that would permit carriers such as AT&T to attract necessary capital.[30]

4. The Commission's Rules Must Permit Each Cable Company to Have a Nonconfiscatory Rate.

The Farmers Union, Jersey Power & Light, and AT&T cases stand for the proposition that each cable company is entitled to argue that the rates set by the Commission or a local franchise authority are not just and reasonable because they do not fall within the zone of reasonableness. Each operator is entitled to rates that are high enough to maintain credit and attract capital. Each operator is entitled to rates that earn a return to equity owners that is commensurate with the returns on investments in other enterprises having a corresponding level of

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[29] Id. at 1391-1392, citing FPC v. Hope, 320 U.S. at 602.

[30] "We are confident that the Commission can imagine other schemes that would not tend to prevent carriers from earning the return needed to enable them to attract necessary capital. It is of course the Commission, not this court, that is empowered to exercise its judgment in choosing a course of action. We do not mean to suggest that any one valid course of action is preferable to any other. If the Commission's choice is to survive judicial scrutiny, however, it must conform to the Commission's understanding of its task. If the Commission wishes to reformulate that understanding, then to the extent that it is 'changing its course[, it] must supply a reasoned analysis indicating that prior policies and standards are being deliberately changed, not casually ignored ...'" Id. at 1392-1393.

risk. Each operator is entitled to make a showing that the Commission or franchise authority has set rates outside the zone of reasonableness or that the franchise authority or Commission did not engage in a reasonable balancing of the interests of consumers and investors. The FCC's rules must take into account that the Constitution requires that cable companies be able to maintain their access to capital markets, have the ability to pay dividends, and be generally financially secure. Finally, the Commission is not required to pursue rules akin to those applied to regulated utilities, as the courts have expressed their confidence in the ability of administrative agencies to create rate rules that protect the financial integrity of regulated companies (cable television operators in this case).

The Supreme Court described the risks faced by traditional utilities in its most recent interpretation of the Hope standards by stating:

> The risks a utility faces are in large part defined by the rate methodology because utilities are virtually always public monopolies dealing in an essential service, and so relatively immune to the usual market risks.[31]

Cable television is neither a monopoly nor does it deal with an essential service, and it is not at all immune from usual market risks.

[31] Duquesne Light Company v. Barasch, 488 U.S. 299, 315 (1989).